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# The Eastern Bloc Gets By Without a Summit

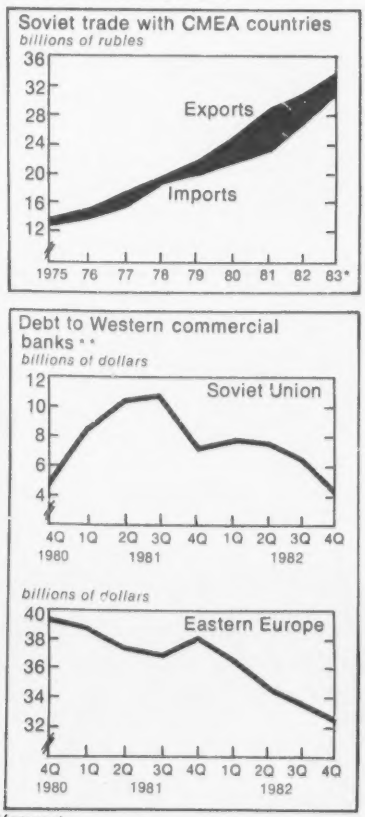
The squabbles over exchange rates and budget deficits that clouded the Williamsburg summit seem insignificant compared with the current conflicts within the Council for Mutual Economic Assistance (CMEA). Problems among leaders of the Soviet Union and Eastern Europe are so severe —and compromises so elusive—that the economic summit scheduled by the Eastern bloc for this spring had to be indefinitely postponed.

CMEA economic summits generally serve to legitimize changes in CMEA rules or programs previously negotiated. Currently, many East Europeans are dissatisfied with the bilateral trade procedures and cumbersome clearing arrangements that have frustrated multilateral trade and financial flows within the region. Although demand for many CMEA products—particularly fuels, raw materials, and food—is high, the transferable ruble, which is the clearing unit in intra-CMEA trade, cannot command these goods without explicit authorization. As a result, the growing volume of multilateral trade within the CMEA is transacted at world-market prices, cleared in convertible currencies, and at times brokered through Western intermediaries. In 1982, when intra-CMEA trade grew by 10.5%, the total assets of IBEC (the CMEA clearing bank) actually fell 8%. In addition, the Soviet Union, the dominant creditor in the bloc, has preferred "supra-national coordination" of national investment and trade programs over any trend toward multilateral trade and finance.

Conflicts over resource transfers—namely, the level of allocation of Soviet subsidies to Eastern Europe—present even more serious problems. Driven by a five-year moving-average pricing formula, the value of Soviet net exports to the CMEA surged to 5 billion rubles in 1981 from 2.9 billion in 1980. Soviet insistence on a reduction of this burden in net terms led to a 16.5% increase in CMEA exports to the USSR in 1982, cutting the deficit to 3.7 billion rubles; further reductions are anticipated in 1983. To complicate financing problems, there has been no give on the part of the Western capital markets. East European net debt to Western banks has dropped nearly $7 billion over the past two years.

So far, the Soviet Union has been successful in its bilateral negotiations with Eastern Europe and has sought to avoid an active summit that might collectively examine the issues of resource transfers. To the surprise of some, the economies of Eastern Europe did not collapse under the severe circumstances of 1980-82, and therefore, the Soviet strategy has worked. Consequently, any CMEA reforms will probably be delayed until similar debates within the Soviet economy itself are settled.

CMEA trade and debt to the West




*forecast
**net liabilities

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*Looking beyond Switzerland's current economic indicators.*

At first glance, recent statistics on the Swiss economy seem somewhat disappointing: The trade deficit in each of the first four months of 1983 has been considerably wider than in the same month of 1982. Consumer prices have been about 4.5% above last year's levels, while M1 remains about 15% higher than its level in the first quarter of 1982. These data are misleading however. The trade deficit reflects imports of new aircraft from the United States, together with a rebuilding of oil inventories that followed the rundown of stocks at the end of 1982 in anticipation of lower oil prices. Thus, the balance of trade is expected to improve over the year while Switzerland's traditional surplus on invisibles will give the country a current-account surplus of some 5 billion Swiss francs. The consumer price index is strongly influenced by housing costs, which will be virtually stable over the near term and can be expected to bring down the measured inflation rate to 3% by year end. Finally, today's high year-on-year money-supply numbers are primarily a reflection of last year's rapid growth. Most forecasters agree that the Swiss National Bank is likely to hold 1983 money growth very close to its stringent targets. This picture suggests that the Swiss franc should once again begin to appreciate against the dollar before the year is out.

*Stringent policies yield optimistic forecast of Belgium's current account.*

The restrictive policies introduced by the government of Belgium some sixteen months ago—devaluation, cuts in real wages, and tighter control of public expenditures—are beginning to bear fruit. Provisional estimates indicate that the current-account deficit last year fell to 122 billion Belgian francs, from 150 billion in 1981. The improved trend that set in during the second half of 1982 is expected to continue this year, resulting in an even sharper reduction in the deficit for 1983 and a chance that the current account will be virtually balanced by 1984. This forecast assumes, however, that demand continues to recover in Germany and that the Martens government succeeds in implementing a planned further reduction in real wages this year. A stronger current account would then relieve incipient pressure on the Belgian franc in the European Monetary System, allowing lower Belgian interest rates and a badly needed recovery in private capital investment.

*Portuguese economy still in need of a firm hand.*

Although Portugal's April election gave the Socialist Party the largest number of seats in the new parliament, it did not produce an absolute majority. Discussions have now continued for over a month between the Socialists and the Social Democrats in an attempt to form a coalition government. While final agreement has not yet been reached, progress is being made in securing external funds to finance Portugal's current-account deficit, which reached nearly $3.3 billion in 1982. The Bank for International Settlements has provided a $400-million short-term bridge loan, and a consortium of international banks has just raised a $300-million syndicated loan. In April, the previous government devalued the escudo by 2% and increased the monthly crawling peg adjustment to 1% in a delayed reaction to the March EMS realignment. Although this was accompanied by a rise in commercial-bank interest rates, further deflationary policies will be necessary if the balance-of-payments deficit is to be reduced significantly.

*Korean economy showing growth rebound, still low inflation.*

The early months of 1983 have brought some encouraging signs of improvement in the Korean economy. Industrial output rose by approximately 14% in the first quarter. And while exports in the first four months of the year were only 1.4% higher than in the same period of last year, order books in some industries have been improving. In particular, ship-building orders are up sharply. The Korean government recently announced that first quarter GDP growth was over 9% at an annual rate and officials are projecting 7.5% growth for the year as a whole. Meanwhile, the rate of inflation has remained extremely low. The consumer price index for April rose at a year-over-year rate of only 4.3% and wholesale prices were up only 1%. Thus, the large increase in the money supply that occurred in the third quarter of 1982 has helped to stimulate recovery but so far has not generated any inflationary consequences.

*Decline in imports will counterbalance Peru's export setback.*

The adverse weather conditions suffered by Peru in the first few months of the year will have a major impact on 1983 exports. First-quarter exports were down 17% from the same period in 1983 owing to damages caused by rains, floods, landslides, and—in southern Peru—droughts. Earnings from cotton, Peru's second most important cash crop, were off 89%, while minerals and petroleum export earnings fell 24% and 20%, respectively. Since only part of the damage is recoverable, total exports for the year are now likely to reach only $2.9 billion—markedly lower than the $3.3 billion projected only a few months ago. As far as Peru's current-account balance is concerned, however, a decline in imports will completely offset the reduction in exports. First-quarter imports dropped 29% below last year's levels. Capital goods showed the greatest loss, owing to the sharp slowdown in economic activity and declines in both public-sector and foreign investment. Expectations are that imports for the year will also total $2.9 billion. With the services deficit projected at $1.3 billion and net transfers at $200 million, Peru's current-account deficit is likely to reach $1.1 billion this year.

*Honduran economic turnaround awaits resolution of region's political crisis.*

The political crisis in Central America has taken a high toll on the Honduran economy. GDP stagnated in 1981 and 1982, and both private investment and exports fell drastically. This is all the result not only of recession-depressed prices for export commodities but also of the political turmoil that has scared away private investment. The government is successfully implementing an austerity program along the usual IMF guidelines. Honduras will also receive $250 million of foreign loans and aid this year. But neither the IMF nor foreign assistance will reverse the deterioration of the Honduran economy until the political crisis in Central America is resolved.

*Additional development rephasing ordered to ensure Indonesian creditworthiness.*

In a further attempt to adjust to the consequences of the steep drop in oil prices, the Indonesian government recently ordered the review of all government projects financed by commercial credits or requiring foreign exchange. This dramatic move goes even further than the government's previous decision to rephase several major development projects, including a $1.6 billion olefin petrochemical complex, a $1.5 billion aromatics plant, a $1.35 billion oil refinery, and a $600 million alumina refinery. With regard to those projects, the government had indicated that it would complete only those phases of the projects that it could afford—such as engineering design; actual construction work in many cases will be delayed indefinitely. Now other projects are likely to be similarly affected. By reducing import requirements, the rephasing of the country's development projects is expected to ease pressure on the current-account deficit, which soared to $6.8 billion in the year ending March 31. Thus the government's latest action is a further strong signal that the government is determined to live within its means and maintain its creditworthiness.

*UAE surplus shrinking despite official measures to keep tabs on spending.*

The United Arab Emirates (UAE) registered an estimated current-account surplus of $6 billion last year, down noticeably from just over $9 billion in 1981. This occurred despite a 4% drop in merchandise imports to about $9.3 billion (c.i.f.). The decline in the surplus was attributable to a 17% fall in the UAE's merchandise exports to $18.1 billion, the result of significantly lower oil revenues reflecting weak world demand: Not only did petroleum production shrink by 19% to 1.2 million barrels per day (mbd) but the weighted average oil export price also fell by 5% to about $34.35 per barrel. Even if state budget cutbacks hold merchandise imports and other payments to last year's level, the current-account surplus will shrink further this year because oil revenues are projected to fall again. The weighted average price has already been cut to $29.30 per barrel as of March 1, and continued soft world demand will probably keep the UAE's oil output close to its OPEC-assigned quota of 1.1 mbd. Consequently, it is unlikely that the UAE's surplus will exceed $3 billion in 1983.

# The Increasing Irrelevance of M1

In Pavlovian fashion, the money markets have reacted to the more-than-$13-billion rise in M1 since April 27 by driving up interest rates. Short-term rates have posted gains in the range of 20-35 basis points since this most recent acceleration in M1 growth began.

The response of the market to this unexpected upturn in the money numbers, however, has been a bit overdone. The days are long gone since the M1 monetary aggregate was a reliable indicator of future Federal Reserve policy and the course of the economy. The measure is increasingly plagued by distortions, either from technical influences or possibly as a result of a shift in money demand. As a consequence, the number has lost most of its informational content.

This is especially true of the post-April 15 numbers, which have been particularly distorted by interest-payment reflows. Because of the institutional structure of the debt markets and the borrowing patterns of the government sector, debt-servicing flows tend to swell the level of monetary balances. Normally, the market simply dismisses these reflows as a seasonal phenomenon that will be purged in the process of seasonally adjusting the data. This time, however, unique trends have come into play that have magnified the impact of the reflows.

First, the run-up in interest rates over the past two years has resulted in a corresponding increase in interest reflows to households. Interest income as a proportion of personal income rose from just over 12% in 1980 to nearly 14.5% in 1982, and so far in 1983 it is hovering around 14.3%. These record reflows are not fully offset by the Fed's seasonal-adjustment factors, which are based on much smaller levels of interest payments. Consequently, the reflows have induced swelling of the monetary aggregates around payment periods.

Second, because the federal, state, and local governments had record deficits to be financed, the quantity of coupon securities issued in 1982 reached unprecedented levels. The federal government was a net credit-market borrower of $161.3 billion in 1982, almost double 1981's $87.4 billion. At the same time, state and local governments tapped the credit markets for $47.2 billion last year, more than twice the $22.3 billion raised in 1981. This trend necessarily implies that record interest payments will be made in 1983. And these payments will continue to swell the monetary aggregates as funds work their way through the clearing process. Moreover, the crunch usually comes in the April-June period because federal, state, and local governments time their debt servicing to fall shortly after tax collection dates.

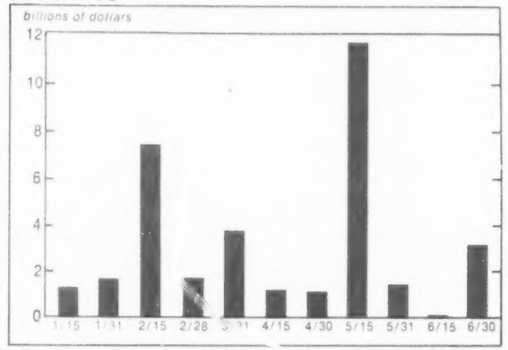
Third, individual investor participation in the government and municipal securities markets has gone up in recent years. This is especially true in the municipal market, where individual investors have become a dominant supplier of new funds. This is significant for the measurement of M1 because these investors—unlike commercial banks—tend to let interest accumulate in deposit accounts rather than immediately reinvesting in comparable types of debt instruments. The reason for this is that individuals' portfolios usually involve less-active management and higher transaction costs.

While this reflow effect might explain the most recent acceleration in M1 growth, it does not account for the persistent rise since the fourth quarter of 1982. The rapid M1 growth over the last 10 months in all likelihood has stemmed from the Fed's accommodation of changes in money demand. In contrast, the bloating of the money supply that has resulted from the concentration of interest reflows is a temporary phenomenon that will eventually subside.

In the interim, however, the swelling of M1 could have some adverse policy implications. The market, viewing the above-target money-supply growth, drives up interest rates in anticipation of a Fed tightening—or out of fear that the Fed has succumbed to an unabashed reflationary stance. In either case, the move risks aborting the recovery and placing the world financial system under renewed strains.

While there are reasons to believe that the money growth of the past 10 months has not been inflationary thus far—since it stems from balances holders do not intend to spend immediately—it nonetheless carries inflationary potential. The risk of renewed inflation comes later when the money demand and technical distortions subside. The periodic jumps in interest rates are more the result of fears bred by uncertainty over Fed actions in the short run than concern over future inflation. At present, the only guide the market has to monetary policy are the unreliable and distorted monetary aggregates. To wean the market from the M1 fixation, the monetary authorities need to outline clearly and thoroughly the policies they intend to follow and to define how the monetary aggregates figure into policy strategies. Unless they do this, they and the economy will be captive to the uncertainty-induced waves of optimism and pessimism that are sweeping through the financial markets. *Vincent G. Salvo*

Interest due on marketable U.S. Treasury securities*




*Notes and bonds, all maturities

## Asia and Oceania — Bimonthly Survey of Business and Finance

| COUNTRIES | CURRENT BUSINESS CONDITIONS | EXPORTS | | GNP IN 1981 | | BALANCE OF PAYMENTS | | | | | | MONEY AND BANKING | | | | | | | COUNTRIES |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | | | | | 12-month changes | | | | exchange rate in U.S. dollars | change from year earlier | | |
| | | 6 months ending | 12-month change | in billions of dollars | $ per capita | latest data | reserves (less gold) in million $ | 12-month change | months of imports covered | use of IMF credit, millions of dollars | current influences on payments | latest data | consumer prices | latest data | money supply(M1) | June 1, 1983 | | current monetary conditions | |
| Asia | | | | | | | | | | | | | | | | | | | |
| Bangladesh | Government's favorable attitude attracting new foreign investment proposals. | Dec. | +12% | 10.8* | 120 | Mar. | 246 | + 17% | 1.4 | 406 | Western donors pledge $1.7 billion in aid for fiscal 1983-84. | Dec. | + 5% | Dec. | +11% | .0415 | −25% | Private-sector credit up sharply in early 1983. | Bangladesh |
| Burma | Government slates cutback in investment programs to halt reserve loss. | Dec. | −29% | 5.8* | 159 | Mar. | 53 | − 75% | 1.8 | 70 | Overall deficit widened markedly in fiscal 1982-83; reserves down sharply. | Dec. | + 4% | Aug. | + 9% | .1279 | − 3% | Kyat remains pegged to SDR. | Burma |
| China, People's Republic | Industrial output in first quarter was 6.9% above previous year. | Dec. | + 3% | 260.0 | 260 | Dec. | 11,339 | +125% | 8.0 | 492 | IMF will be repaid ahead of schedule this year. | Dec.'81 | + 3% | Dec. | + 8% | .5025 | − 3% | Investment spending soared in late 1982, early 1983. | China, People's Republic |
| Hong Kong | With property and stock markets depressed, hopes pinned on export recovery. | Mar. | + 4% | 24.2 | 4,695 | n.a. | — | — | — | — | First-quarter trade deficit falls as exports start to pick up. | Mar. | +11% | Mar. | +15% | .1377 | −21% | Rates boosted to halt HK dollar tailspin. | Hong Kong |
| India | Industrial licensing restrictions relaxed further to spur production. | Sept. | − 9% | 161.4* | 236 | Oct. | 3,980 | − 19% | 3.8 | 2,876 | Import policy eases restrictions for exporters, tightens in other respects. | Feb. | + 9% | July | + 8% | .1000 | − 9% | Cash-reserve ratio raised to absorb excess liquidity. | India |
| Indonesia | Government rephasing of development projects will depress domestic activity. | Aug. | −15% | 81.5 | 541 | Jan. | 3,060 | − 44% | 2.3 | 70 | Project rephasing will help to narrow current-account gap. | Jan. | +10% | Nov. | +19% | .00103 | −31% | Tighter credit conditions likely. | Indonesia |
| Japan | Inventory adjustment making headway; unemployment remains high. | Feb. | −12% | 1,142.0 | 9,707 | Mar. | 24,189 | − 11% | 2.3 | 0 | Depressed imports help push first-quarter current surplus to $3.5 billion. | Apr. | + 2% | Feb. | + 2% | .00416 | + 2% | Stronger yen still a prerequisite for monetary easing. | Japan |
| Korea | Industrial production picking up in anticipation of export recovery. | Feb. | + 1% | 62.3 | 1,610 | Mar. | 2,269 | − 20% | 1.1 | 1,228 | Jan.-Apr. current-account deficit widened compared to year-earlier period. | Mar. | + 5% | Jan. | +48% | .0013 | −13% | Monetary authorities following a more restrictive policy. | Korea |
| Malaysia | Recovery hinges on pick-up in external demand. | Nov. | +10% | 24.0 | 1,666 | Feb. | 3,867 | + 6% | 3.7 | 341 | Rubber, tin prices recover strongly; LNG exports to Japan resume. | Dec. | + 5% | Dec. | +13% | .4347 | 0 | Domestic borrowing restrictions on foreign companies lifted. | Malaysia |
| Pakistan | Sixth Plan (fiscal 1983-84 thru 1987-88) will shift government investment to agriculture and energy. | Jan. | − 8% | 30.9* | 360 | Mar. | 1,467 | + 79% | 3.2 | 1,321 | Western donors pledge $1.4 billion in aid for 1983-84. | Feb. | + 5% | Feb. | +21% | .0775 | −23% | Rupee stable against U.S. dollar as inflation slows. | Pakistan |
| Philippines | World Bank loan of $302 million supports reforms in trade, energy, and industrial-investment incentives. | Oct. | −10% | 38.7 | 781 | Mar. | 1,694 | − 14% | 2.5 | 1,050 | First-quarter current-account deficit narrowed slightly from year earlier. | Dec. | + 7% | Jan. | + 5% | .1050 | −15% | Ruling reduces bank foreign-exchange holdings. | Philippines |
| Singapore | Government spending remains main stimulus. | Jan. | − 5% | 12.5 | 5,121 | Dec. | 8,480† | + 12% | 3.7 | 0 | Indonesian austerity measures hurt intercountry transactions. | Feb. | 0 | Dec. | +13% | .4789 | + 1% | Credit conditions easy. | Singapore |
| Sri Lanka | Private sector sluggish owing to overvalued rupee, high real interest rates. | Nov. | −11% | 4.4 | 294 | Feb. | 293 | − 3% | 1.8 | 340 | Prices rise for traditional export commodities. | Jan. | + 6% | Dec. | +17% | .0459 | − 8% | Interest rates cut, but real rates still high. | Sri Lanka |
| Taiwan | Restrictive 1983-84 budget provides no stimulus. | Jan. | + 2% | 46.0 | 2,559 | Feb. | 9,420 | + 27% | 6.1 | 0 | Import surcharge reduced; export recovery seems to be underway. | Feb. | + 4% | Feb. | +19% | .0250 | − 3% | Stock market booming. | Taiwan |
| Thailand | No changes in economic policy anticipated under new government. | Dec. | − 8% | 36.1 | 750 | Mar. | 1,601 | + 29% | 2.2 | 758 | First-quarter trade deficit widened sharply but overall deficit much smaller. | Feb. | + 3% | Sept. | +11% | .0434 | − 6% | High real interest rates depress credit demand. | Thailand |
| Oceania | | | | | | | | | | | | | | | | | | | |
| Australia | Business cycle expected to bottom out soon. | Jan. | − 3% | 158.0 | 10,632 | Mar. | 5,615 | +240% | 2.7 | 35 | Capital flows back in as result of devaluation. | Dec. | +11% | Feb. | + 1% | .8810 | −16% | Interest rates fall following devaluation. | Australia |
| New Zealand | Wage-price freeze extended through February 1984. | Feb. | − 3% | 23.5* | 7,510 | Feb. | 889 | +111% | 2.1 | 0 | Current-account deficit almost doubled in 1982. | Dec. | +15% | Jan. | + 2% | .6609 | −13% | M2 growth only 2% in 1982, down from 12% in 1981. | New Zealand |
| Papua New Guinea | Rising copper prices will boost slow economy. | Dec. | − 8% | 2.5 | 830 | Mar. | 301 | − 11% | 3.0 | 49 | Somare resists calls for another devaluation. | Dec. | + 7% | Dec. | − 5% | 1.1873 | −17% | March devaluation expected to push inflation to 10%-11%. | Papua New Guinea |

*Fiscal year †Includes gold holdings

# World Interest Rates

*market rates as of June 1, 1983; bond yields as of May 27, 1983*

| in percent per annum | U.S. | Canada | Britain | Belgium | France | Germany | Italy | Netherlands | Switzerland | Japan |
|---|---|---|---|---|---|---|---|---|---|---|
| **Central Bank Discount Rate** | 8.50 | 9.50 | 10.063 intervention rate | 9.50 | 9.50 | 4.00* | 17.00 penalty rate 20.00 | 4.50 | 4.00 | 5.50 |
| **Day-to-Day Money** | 8.75 June 2 | 9.25 | 10.00 | 8.25 | 12.50 | 5.00* | 18.00 | 5.75 | 3.125 1-month Euro-Swiss fr. rate | 6.125 |
| **Treasury Bills** 91-day, Middle Rates | 8.57 | 9.30 | 9.875 | 10.00 | n. a. | n. a. | 15.952 85 days | no dealing | no market | 5.375 |
| **Commercial Paper** prime, 3-month, asked | 8.75 finance paper discount basis | 9.40 finance paper 15% tax w/h | 9.844 | 9.40 Certified | 9.563 Interbank | no market | no market | no market | no market | not traded |
| **Bankers' Acceptances** 3-month, asked | 8.75 | 9.35 15% tax w/h | 9.844 | 9.40 Certified | not traded | 5.00* | 18.55 | no market | 4.938 | no market |
| **Government Bonds** Long-term, new and old issues, average yield | 10.85 | 11.81 | 10.07 | 11.325 | 13.71 | 7.95† | 18.40 | 8.75 | 4.47 | 7.261 |
| **Industrial Bonds** prime, long-term, new and old issues, average yield | 11.65 Aa Industrials | 12.05 | 12.03 | 11.645 | 14.85 | 8.00† | 17.92 | 8.94 | 5.87 | 6.48 |
| **Bank Short-Term Rate** (prime rate) | 10.50 | 11.00 | 10.00 | 14.00 | 14.55 | 8.00* | 18.75 ⅛ qtrly fee on outstdng. | 7.50 | 7.50 | 6.00 |
| **Bank Time Deposits** 3-month | 8.75 Cert. of Dep. | 9.35 | 10.375 | 9.95 | 12.563 | 5.10* | 11.50 | 6.25 large deposits | 3.75 residents only | 3.75 20% tax w/h |
| **Eurocurrencies** 3-month, asked | 9.75 | 9.813 | 10.50 | no market | 13.938 | 5.563 | no market | 6.50 | 5.125 | 6.75 |
| **Exchange Rates—in U.S.$** rates floating against the $ | — | .8128 | 1.594 | .0197 | .1310 | .3933 | .00067 | .3499 | .4743 | .0042 |
| **Forward Exchange Cover** 3-month, in percent p.a. *D* = discount, *P* = premium | — | 0.098 *D* | 0.728 *D* | 0.162 *D* | 4.275 *D* | 4.272 *P* | 6.636 *D* | 3.43 *P* | 4.976 *P* | 3.167 *P* |

**Eurodollar Deposits**
(London, interbank, bid)
June 1

| | |
|---|---|
| 7-day | 9.125 |
| 1-month | 9.313 |
| 3-month | 9.563 |
| 6-month | 9.813 |

**International Arbitrage**
(3-month, hedged) + *in favor of U.S. dollars*

| | |
|---|---|
| U.S.-U.K. Treasury Bills | −0.442 |
| U.S.-Canada Treasury Bills | −0.297 |
| U.S.-Canada Finance Co. Paper | −0.298 |
| Eurodollars-U.K. Local Auth. Deposits | +0.166 |

**Eurobonds**
(average yield on recent straight debt issues)

| | |
|---|---|
| U.S. Dollar Bonds | |
| 7 yrs. and under | 11.00 |
| Over 7 yrs. | 11.00 |
| DM Bonds | |
| 7 yrs. and under | 7.75 |
| Over 7 yrs. | 7.75 |

**Gold Price**

London afternoon fixing

**410.00**
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate (prime rate), while including customary commissions, reflect neither other fees nor varying compensating balance requirements.

*Market rates as of May 25, 1983. †Bond yields as of May 20, 1983.

## Current economic indicators of major industrial countries

| | U.S. | Canada | Britain | France | Germany | Italy | Switzerland | Japan |
|---|---|---|---|---|---|---|---|---|
| **Consumer prices*** | (Apr.) 3.9 | (Apr.) 6.6 | (Apr.) 4.0 | (Apr.) 9.1 | (May) 3.0 | (May) 16.4 | (Apr.) 4.5 | (Mar.) 2.3 |
| **Industrial production*** | (Apr.) 1.7 | (Mar.) −2.6 | (Mar.) 1.5 | (Mar.) −0.8 | (Mar.) −7.9 | (Mar.) −9.2 | (Dec.) −8.5 | (Apr.) 1.5 |
| **Trade balance†** *(billions of local currency units)* | (Apr.) −$4.60 | (Mar.) C$1.39 | (Apr.) −£0.36 | (Apr.) −FF1.54 | (Apr.) DM2.67 | (Mar.) −Lit.3,300 | (Apr.) −SF0.83 | (Mar.) ¥684.7 |
| **Money supply** (M1)* | (Mar.) 10.9 | (Mar.) 10.4 | (Mar.) 12.4 | (Jan.) 11.5 | (Mar.) 10.8 | (Dec.) 16.4 | (Mar.) 5.8 | (Feb.) 6.4 |
| **Velocity of money** (M1)* | (Mar.) −4.4 | (Dec.) 0.3 | (Dec.) −1.9** | (Sept.) 0.6** | (Ger.) −3.7 | (Sept.) −1.8** | (Mar. '82) 9.3** | (Dec.) 0.8 |
| **Reserves minus gold** *($ million, change from previous month)* | (Mar.) 29 | (Mar.) −363 | (Mar.) −390 | (Feb.) −2,364 | (Mar.) 1,947 | (Mar.) −676 | (Mar.) 700 | (Mar.) 259 |

* Percent change from 12 months earlier. ** based on GDP † Figures are only for the month indicated.

# Putting Budget Deficits Into Perspective

Not since America's 1980 presidential campaign has the U.S. budget deficit been the focus of so much debate. At the recent economic summit in Williamsburg, Virginia, the nearly $200 billion in budgetary red ink expected to be tallied by the United States this fiscal year came under attack as a force behind continued high interest rates and a threat to the still-fragile economic recovery. In pre-summit rhetoric, the French were particularly vehement in their criticisms, charging that the huge U.S. deficit resulted in high U.S. interest rates that attracted dollars out of Europe into investment in the United States—raising the value of the dollar on the foreign-exchange markets and keeping persistent downward pressure on the franc.

Some of the fears expressed over the U.S. deficit may prove to be misdirected and somewhat overstated in the long run. Nevertheless, the unusual severity of the past recession, in the aftermath of a long and costly battle with inflation, has prompted policymakers and economists to give greater attention to the way in which one country's deficit affects not only its own domestic economy but the economies of other nations as well.

### Cyclical vs. structural deficits

To be sure, the United States is not the only country with budget problems. Public-sector deficits in many other industrial nations are as high or higher as a proportion of GNP (see chart below). But to understand the relative significance of these various shortfalls around the world, it is necessary to put them in economic perspective. The environment in which the deficit occurs has a great deal to do with how each economy is affected. For example, whether the deficit is cyclical or structural in nature, the presence or absence of inflation, and the openness to external trade and capital flows and relative size of the economy in question all can make a big difference in how interest rates, the mix between investment and consumption, and other economic variables are affected.

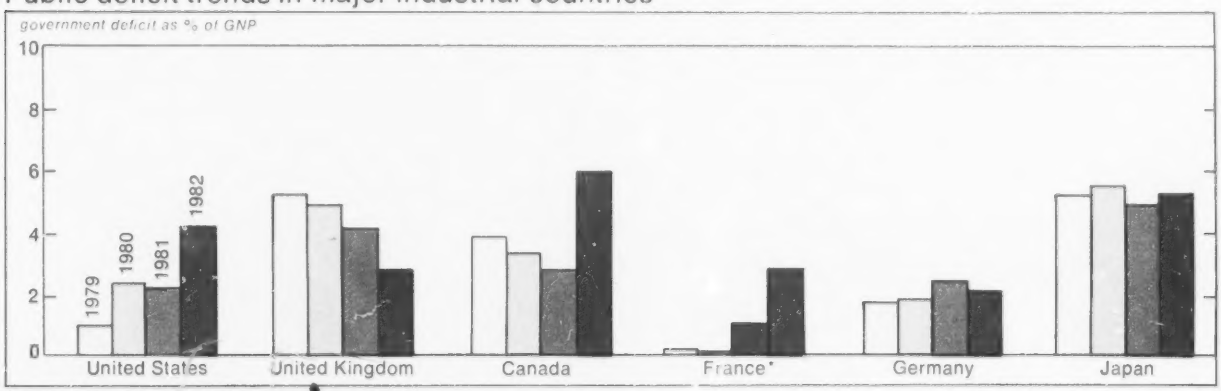
Cyclical deficits arise from shortfalls in government revenue stemming from lower levels of economic activity and from recession-induced government expenditures (mainly transfer payments) to compensate for reductions in private incomes. These deficits are sometimes known as automatic stabilizers because they may support consumer demand during a recession.

Under normal circumstances, cyclical deficits have little net effect on real (inflation-adjusted) interest rates. This is because the rise in government expenditures relative to receipts largely offsets the decline in private-sector investment relative to private-sector saving, which—according to traditional macroeconomic theory—is often the cause of recession. Indeed, in this view, a rise in interest rates coincident with the financing of a cyclical deficit would be counterproductive if the rise deflated the economy further, thereby raising the size of the cyclical deficit to be financed.

Structural deficits, on the other hand—also known as "high-employment" or "full-employment" deficits—abstract from cyclical considerations and measure what the deficit would be if the economy were at or close to its full potential level of output. Often they are interpreted as an indicator of the underlying stance of a country's fiscal policy.

The economic effects of a structural deficit are quite different from those of a cyclical shortfall. To understand why this is so, it is useful to start by taking the case of an economy closed to foreign trade and capital flows and with a stable price level. It is possible to simplify even further by assuming no change in the private sector's willingness to save. Under these conditions, a rise in the government deficit reduces the

Public deficit trends in major industrial countries




*Government deficit as % of GDP
Data: International Monetary Fund and Chase estimates

## Putting Budget Deficits Into Perspective *(continued from page 7)*

economy's aggregate savings, therefore private investment must also fall. The mechanism that brings this about is generally a rise in real interest rates.

The size of these effects—the rise in real interest rates and the fall in private investment—depends on the interest sensitivity of both private savings and investment. The higher the interest sensitivity of private savings, the lower will be the rise in interest rates and the smaller will be the associated fall in private investment. And the higher the interest sensitivity of private investment, the lower the rise in interest rates but the larger the fall in private investment.

While a rise in the structural deficit leads to a fall in *private* investment, this is not necessarily the case for *total* investment. That depends on whether the higher government structural deficit is used to raise *public* investment. If it is, total investment will rise, but by less than the rise in public investment. The size of the effect again depends on the interest sensitivities of private savings and investment. Only if private savings are completely interest-insensitive will there be total "crowding out" of private investment equal to the rise in public investment.

### The effects of inflation

The analysis so far has assumed a closed economy with the government's deficit being financed by the issuance of bonds to residents rather than by printing money. If money were printed instead, inflation would sooner or later result.

In the long run, the analysis typically remains valid whether the deficit is monetized or not. Given full employment, monetization should affect only the general price level and *nominal* interest rates, not the competing claims on *real* resources; in other words, relative prices should be unaffected by monetization. However, in the short run, inflation complicates the picture. If savers, investors, and institutions are not set up to anticipate and react to inflation—something that is very unlikely in the long run—unanticipated inflation will act as a tax on savers and a subsidy to investors: The realized real interest rate will fall short of the anticipated one (on which agents base their behavior) by the amount of unanticipated inflation. This accounts for the experience in the late 1970s when real interest rates were even negative for a time. Furthermore, unanticipated inflation is likely to raise the government's real tax take, thus reducing the deficit to be financed. In short, unanticipated inflation acts as a tax to finance the deficit—a tax that begins to disappear once inflation is anticipated.

Even if savers and investors are fully equipped to react to inflation, a *change* in inflation expectations may well have interim real effects on savings and investment behavior. This happens when a change in inflation expectations affects the real value of financial assets, causing individuals and businesses to adjust their flow of savings until real financial assets again reach their desired level.

### Open economies

The analysis changes somewhat if it allows for foreign trade and capital flows. Then the extra savings necessary to finance a government's structural deficit can come from foreigners, allowing private investment at home to be maintained. A particular country as a whole can invest more than it saves, with the difference being a current-account deficit. However, in order to run such a deficit, the country must offer foreigners a higher (risk-adjusted) real rate of return, normally in the form of higher real interest rates. Thus, even in an open economy, a rise in the government's structural deficit implies somewhat higher real interest rates and somewhat lower private investment than in the absence of a deficit. The size of this effect now depends, among other things, on the interest sensitivity of foreign capital flows. Furthermore, in an open economy, there are feedback effects to the rest of the world if the country's structural deficit is large relative to the supply of world savings. By absorbing a major share of world savings, a large structural deficit in a large country will therefore raise the level of real interest rates in the world as a whole.

Interpreted in this light, the concerns expressed by European, Canadian, and Japanese leaders over the structural budget deficits projected for the United States over the next few years appear reasonable. Fears are that a continuation of shortfalls of such a magnitude will not only keep real interest rates from falling, but also lead to a resurgence of rates in the United States and in Europe as well. Furthermore, America is not the only country in the industrial world suffering from a structurally overextended budget. And given the inherent political difficulties in raising taxes or lowering public-sector expenditures, there are growing concerns that these deficits will be financed by a raising of the "inflation tax." These fears are undermining the creditibility of the current anti-inflation policies—and helping to hold long-term interest rates at excessively high levels relative to *today's* inflation rates. In the 1970s, financial savers were taxed by underestimating actual inflation rates. Today, they are wary of repeating that mistake.

*George de Nemeskeri-Kiss*
*Chase London*